Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

NO. 78-442

OTM CORPORATION,

Petitioner,

VS.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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INDEX

LIST OF AUTHORITIES

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Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit entered in the above entitled cause on May 8, 1978.

CITATIONS TO OPINIONS BELOW:

The opinion of the District Court, printed in Appendix A of the separate bound Appendice, apparently is unreported. The opinion of the United States Court of Appeals for the Fifth Circuit is printed in Appendix B of the separate bound Appendice and is reported at 572 F.2d 1046.

JURISDICTION

1. The Judgment of the Circuit Court of Appeals was dated May 8, 1978, and it was entered on the same day.
2. The Order overruling the Motion for Rehearing was dated June 27, 1978.
3. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1346.

QUESTION PRESENTED

Is the Government required under Section 482 of the Internal Revenue Code, 26 U.S.C. 482, to allow as deductions to the petitioner the equipment rentals which petitioner paid to a related corporation (TIERCO) where the related corporation included these payments in its income?

STATUTES INVOLVED

The Statutes involved are Section 482 and Section 162 of the Internal Revenue Code of 1954, 26 U.S.C. Sections 162 and 482. These sections of the Internal Revenue Code of 1954 are printed in Appendix C of the separate bound appendice.

STATEMENT

This is a civil action for the recovery of federal income taxes for the fiscal years ended September 30, 1955 through 1958.

The facts were stipulated in the Trial Court.

OTM Corporation, the petitioner, hereinafter called taxpayer, filed its claim for refund for the years at issue and took the position that it was entitled as deductions in computing its taxable income the equipment rentals which it paid to a related corporation, Texas Industrial Equipment Rental Company (TIERCO). The taxpayer's position was that under the provisions of Section 482 and the regulations thereunder that it was entitled to these equipment rentals as a business expense, since TIERCO had included these payments in its income.

In the Trial Court, the parties stipulated as to the reasonable rental value of

the equipment involved, and the taxpayer's income taxes were recomputed based on this stipulation and judgment was entered in favor of the taxpayer for the sum of $45,754.00, which represented a refund of income taxes of $17,474.00, negligence penalty of $654.00 and interest at $27,626.00. In connection with the stipulation, the taxpayer reserved the right to present to the Trial Court the legal issue of whether it was entitled to claim the rest of the rental which it paid TIERCO as a deduction since Internal Revenue Service had not reduced the rental income of TIERCO by the amount of the rent expense that Internal Revenue Service had disallowed to the taxpayer. Internal Revenue Service taxed to TIERCO the amount that taxpayer had paid it as rental income, but Internal Revenue Service did not allow the taxpayer a rental expense deduction for $74,224.08 which it had paid TIERCO during the years

at issue.

The Trial Court ruled that Section 482 did not apply to this case but that Section 162 applied. Judgment was entered accordingly. The Court of Appeals for the Fifth Circuit sustained the Trial Court.

Section 162 in general allows as a deduction only reasonable rental expenses.

The taxpayer's position is that Internal Revenue Service disallowed part of the rent which taxpayer paid to TIERCO, a related taxpayer, because Internal Revenue Service determined that the rents were not negotiated on an arm's length basis. This is an allocation of income or deductions among related taxpayers, and Section 482 applies. However, Internal Revenue Service did not reduce the rental income to TIERCO by the amount of the disallowed rents to the taxpayer even though the statute of limitations applicable to TIERCO had not expired at that time. Because of Internal Revenue

Service's own rulings and court decisions, Internal Revenue Service cannot disallow the rental deduction to the taxpayer, because they did not reduce TIERCO's income. The Government's position is that the rent was disallowed under Section 162 and that it was not required to make the correlative adjustment to TIERCO's income.

ARGUMENT

THE GOVERNMENT WAS REQUIRED UNDER SECTION 482 OF THE INTERNAL REVENUE CODE, 26 U.S.C. 482, TO ALLOW AS DEDUCTIONS TO THE PETITIONER THE EQUIPMENT RENTALS WHICH THE PETITIONER PAID TO A RELATED CORPORATION (TIERCO) WHERE THE RELATED CORPORATION INCLUDED THOSE PAYMENTS IN ITS INCOME.

The issue is whether Section 482 or Section 162 applies. The taxpayer contends that Section 482 applies, whereas the Government contends that Section 162 is applicable.

Section 482 provides:

> Sec. 482. Allocation of income and deductions among taxpayers.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distributions, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of

any of such organizations, trades, or businesses.

Section 162 provides:

> Sec. 162. Trade or business expenses.
>
> (a) In general.- There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--
>
> * * * *
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * *

The taxpayer and TIERCO were related entities.

The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer; Reg. 1.482-1(b)(1). The Commissioner has authority in determining the correct taxable income of the controlled

members to make such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between the controlled taxpayers and the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer; Reg. 1.482-1(b)(1). The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), or any other adjustment which may be appropriate under the circumstances; Reg. 1.482-1(d)(1). Whenever the Commissioner makes adjustments to the income of one member of a group of controlled taxpayers, he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation; Reg. 1.482-1(d)(2)(underscoring

supplied by taxpayer). An adjustment to reflect an arm's length rental charge for the use of the tangible property of a member of a controlled group is included in the provisions of Section 482; Reg. 1.482-1(d)(2), Example 1. Also see Reg. 1.482-2(c)(1) which says where one member uses the tangible property of the other member "without charge or at a charge which is not equal to an arm's length rental charge, the district director may make appropriate allocations to properly reflect such arm's length charge."

IRS recognizes the principle that if an adjustment was made to the income of one member of a controlled group that the corresponding adjustment must be made to the other member of the controlled group. In other words, if the taxable income of one member is increased, the taxable income of the other member must be reduced by the corresponding amount. In Technical

Information Release 838, dated August 2, 1966, Rev. Rul. 67-79, Cumulative Bulletin 1967-1, page 117, IRS said:

> "In cases where, pursuant to the provisions of section 482 of the Internal Revenue Code of 1954, the Service has made adjustments to allocate income or deductions among the members of a group of business entities owned or controlled by the same interests, corresponding adjustments must be made to the income or deductions of the related corporations from which the allocations were made."

In Rev. Rul. 67-79 IRS was explaining its acquiescence in the decision of the Tax Court of the United States in the case of Smith-Bridgman & Co. v. Commissioner, 16 T.C. 287 (1951), Acquiescence C.B. 1951-1, 3; and its position on the decision of the U. S. Court of Appeals for the Sixth Circuit in the case of Tennessee-Arkansas Gravel Co. v. Commissioner, 112 Fed.2d 508 (1940). In each of these cases, IRS had, under the authority of Section 45 of the Internal Revenue Code of 1939 (predecessor of Sec. 482 of the 1954 Code), created

income where none existed under the provisions of Section 45 of the Internal Revenue Code of 1939. In the Smith-Bridgman & Co. case, the taxpayer made interest free loans to its parent company. IRS determined that Smith-Bridgman & Co. had taxable income equal to interest at 4% on these loans. However, IRS did not allow the parent company an offsetting adjustment for this interest expense.

In the Tennessee-Arkansas Gravel Co. case, the taxpayer leased equipment to a controlled corporation rent free. IRS determined that the taxpayer corporation should include in its income $12,000. rental income which it determined was the fair rental value of the equipment. However, IRS did not make the corresponding adjustment and allow the controlled corporation the $12,000. rental expense. The last paragraph of Rev. Rul. 67-79, Page 118, says:

> "The acquiescence in Smith-Bridgman & Co. was intended only to concur in the proposition that appropriate adjustments are to be made to the incomes of both members of the group affected to reflect the allocation. The acquiescence does not override the Service's position as to the scope and purpose of section 482 of the 1954 Code as set forth in existing regulations. Similarly, the Service concurs in the result reached in Tennessee-Arkansas Gravel Co. only to the extent the holding is based on its failure to have made an appropriate adjustment to the income or deductions of the member of the group from which the allocation was made."

Reg. 1.482-1(b)(1) provides:

> (b) Scope and purpose.
>
> (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may

> deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

IRS disallowed the rental deductions to the taxpayer because IRS contends that the payments which were made to the related corporation, TIERCO, were excessive and were not entered into in an arm's length transaction. In enacting Section 482, Congress intended to give IRS a weapon whereby they could allocate income and deductions among related taxpayers so that each would report its true net income. However, Congress wanted IRS to be fair about it and not disallow deductions to one related taxpayer where the correlative adjustment was not made to the other related taxpayer. This is exactly what IRS has done in this situation. Section 482 and the regulations

thereunder prohibit such action on the part of IRS. The rental deductions cannot be denied to the taxpayer when the rental income of TIERCO was not reduced by a corresponding sum.

The Government's position is that the disallowance of the rental expense was done under the provisions of Section 162. Section 162 is the general statute which provides that a business can deduct only ordinary and necessary expenses. If a taxpayer pays excessive rental to a related corporation, then the excess is not deductible under Section 162 because the excess is not an ordinary and necessary business expense.

However, in enacting Section 482, Congress has provided a fair remedy to the Government and to related taxpayers so that if a related taxpayer pays excess rentals that it will not be a "disallowed" deduction as far as the related group is concerned. Section 482 and the regulations thereunder

provides that the excess will not be deductible by the payor provided that the income of the related member receiving the excess is reduced by the excess amount. If IRS makes the correlative adjustment, then each member of the related group will report its correct taxable income. However, if IRS does not make the correlative adjustment, then Section 482 and the regulations thereunder provide that the excess rentals are deductible by the payor or the taxpayer in this case.

Taxpayer submits that it is not an easy matter to know when a rental contract is entered into the "fair rental value" of the item of personal property involved. This is an opinion matter and experts can and do differ as to their opinion. Also, an Internal Revenue Agent can have his opinion and regardless of his qualifications or no qualifications, the burden of proof is on the taxpayer to prove him wrong. Therefore,

Congress, by enacting Section 482, wanted to insure that if the taxpayer guessed wrong or made a wrong decision as to the "fair rental value", that the related group would not pay tax on any more than the total net income of the group. IRS has not followed the mandate of Congress and its own regulations because it has disallowed as rental expense to the taxpayer the sum of $74,224.08 and has not reduced the rental income of TIERCO by that sum. The net effect is that when this suit was filed was that IRS had taxed the related group of the taxpayer and TIERCO on $74,224.08 more than their combined income. This the Government is not permitted to do under the provisions of Section 482.

As far as can be determined, this is the first time that the Government has taken the position that an excess deduction taken by a related member is allowable only under the provisions of Section 162. What

the Government is attempting to do is to eliminate Section 482 from the Internal Revenue Code. Congress is the one to eliminate a law and not IRS. Congress had a purpose in enacting Section 482 and it or its predecessors has been in the Internal Revenue Code for a long time. As stated by this Court in C. I. R. v. First Security Bank of Utah, 92 S.Ct. 1085, 405 U.S. 394, 31 L.Ed.2d 318 (1972), on page 1098, footnote 1:

> "1. Section 482 is not new. It appeared as Section 45 of the Revenue Act of 1928, 45 Stat. 806, and has predecessors in Sec. 240(f) of the Revenue Act of 1926, 44 Stat. 46, and in Section 240(d) of the Revenue Act of 1924, 43 Stat. 288."

In C.I.R. v. First Security Bank of Utah, supra, which was a Section 482 case, at footnote 4, page 1089, this Court said:

> "[4] Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including, lawful structuring (which may include holding companies) to minimize taxes. Perhaps the classic example of this principle is Judge Learned Hand's comment in his dissenting

> opinion in Commissioner v. Newman, 159 F.2d 818, 850-851 [35 AFTR 857] (CA2 1947):
>
> "'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.'"

Section 482 is a specific statute. Section 162 is a general statute. The specific statute should control over the general statute unless Congress has indicated a clear intention otherwise.

Monte Vista Lodge v. Guardian Life Insurance Company of America, 384 F.2d 126, (C.A. 9, 1967) said on page 129:

> ". . .Fundamental maxims of statutory construction require that a specific section be found to qualify a general section. A specific statutory provision will govern even though general provisions, if standing alone, would include the same subject. Karrell v. United States, 181 F.2d 981 (9th Cir., 1950), cert. denied, 340 U.S. 891, 71 S.Ct. 206, 95 L.Ed. 646."

The facts were stipulated in the Trial Court.

The Trial Court found in its findings of fact that the Government disallowed a portion of the rental expense claimed by the taxpayer under the provisions of Section 162. Actually, this is a legal conclusion or the ultimate conclusion on which judgment was based in this case. There is no evidence to support such a conclusion. Taxpayer plead in his complaint that Section 482 was applicable. The Section 482 issue was preserved in the pre-trial order under "contested issues of law", which pre-trial order was approved by the parties and it was approved and entered by the Trial Court on September 2, 1977. The findings by the Trial Court that the Government used Section 162 is clearly erroneous and the ultimate legal conclusion in this case and is reviewable by this Court. United States

v. United States Gypsum Co., 333 U.S. 364, 395; C.I.R. v. Duberstein, 363 U.S. 278, 4 L.Ed.2d 1218, 80 S.Ct. 1190, C.I.R. v. Welch, 345 F.2d 939, (5 Cir., 1965), Chared Corporation, Transferee, v. U. S., 446 F.2d 745 (5 Cir., 1971).

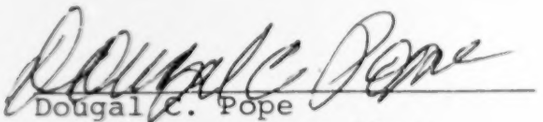
It is the taxpayer's opinion that the issue which is presented in this case is of national importance in connection with income tax matters. Most large and medium sized businesses and many smaller businesses are structured so that there are related parties or businesses involved, and most of these businesses deal with one another where the provisions of Section 482 would come into play. Many of these businesses sell products to one another, rent equipment to one another and engage in numerous business activities between them. By the use of Section 482, these businesses know that if IRS determines that they did not enter into a transaction on an arm's

length basis and if IRS increases the income of one member that IRS must make a correlative adjustment and decrease the taxable income of the other member. However, if this case is allowed to stand, IRS will have swept away Section 482 from the Internal Revenue Code, and they will use Section 162 on these type of cases. This is going to leave uncertainty and confusion among related or controlled entities, and the litigation which this will entail will be endless.

CONCLUSION

This Court should grant certiorari in this case and reverse the judgments of the Courts below.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that I served copies of the foregoing Petition for Writ of Certiorari and the separately bound Appendice on the several parties thereto as follows:

1. On the United States by mailing a copy in a duly addressed envelope with air mail postage prepaid to the Solicitor General, Department of Justice, Washington, D. C. 20530, and by mailing a copy in a duly addressed envelope with air mail postage prepaid to the Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D. C. 20530.

Dated on this the 12th day of September, 1978.

Dougal C. Pope